

**MINUTES OF THE REGULAR MEETING OF THE
ARIZONA STATE RETIREMENT SYSTEM BOARD**

**HELD ON
September 19, 2003
9:30 a.m., MST**

The Arizona State Retirement System (ASRS) Board met in the Conference Room of the Little America Hotel, 2514 E. Butler Avenue, Flagstaff, Arizona. Mr. Karl Polen, Chairman, Arizona State Retirement System Board, called the meeting to order at 9:30 a.m., MST.

The meeting was teleconferenced to the ASRS office at 3300 N. Central Avenue, Phoenix, Arizona and 7660 E. Broadway, Tucson, Arizona 85710.

1. Call to Order; Roll Call, Opening Remarks

Present: Mr. Karl Polen, Chairman (Via Teleconference)
Mr. Norman Miller, Vice Chairman (Via Teleconference)
Ms. Charlotte Borchert
Mr. Jim Bruner
Dr. Chuck Essigs
Dr. Keith Meredith
Mr. Carl Tenney
Mr. Lawrence Trachtenberg (Via Teleconference)
Mr. Steven Zeman

A quorum was present for the purpose of conducting business.

The meeting was turned over to Mr. Jim Bruner, Board Member.

2. Approval of Minutes of the August 15, 2003, Regular Meeting and Executive Session of the ASRS Board

Motion: Dr. Keith Meredith moved to approve the minutes of the August 15, 2003 regular meeting summary of the ASRS Board.

Mr. Carl Tenney seconded the motion.

By a vote of 9 in favor, 0 opposed, 0 abstentions, and 0 excused, the motion was approved.

3. Approval of Consent Schedule

Motion: Dr. Chuck Essigs moved to approve Refunds, Death Benefits, Retirements, System Transfers, and the Applications and Agreements with:

- Western Maricopa Education Center
- Choice Education & Development Corp.
- Luz Academy of Tucson
- Ponderosa Domestic Water Improvement District
- Aha Macav High School
- New School For The Arts Middle School
- Pinewood Fire Department
- Buckeye Valley Fire District

Approve the ASRS Investment Manager contracts for the following:

- Bank of Ireland
- Brandes
- Capital Guardian
- Bank of New York
- BGI-International
- BlackRock
- JP Morgan
- BGI U.S. Debt
- WAMCO (Back-up) and

Move to approve the extension of the contract for actuarial services with bBuck Consultants, Inc., to expire on November 18, 2004.

Ms. Charlotte Borchert seconded the motion.

By a vote of 9 in favor, 0 opposed, 0 abstentions, and 0 excused, the motion was approved.

4. Presentation, Discussion and Appropriate Action Regarding Selection of a Health Insurance Consultant

Dr. Chuck Essigs, Chairman, Health Insurance/Long Term Disability Committee, explained that the Segal Company withdrew its benefits consulting services of assisting the Health Insurance Committee in its retiree health care program deliberations when it became apparent that the strategies being proposed by the Committee were in conflict with the desires of Segal's public sector ASRS employer clients. This led to the Committee reviewing two proposals. The Committee is recommending the selection of Watson Wyatt as the benefits consulting firm.

Motion: Dr. Chuck Essigs moved to appoint Watson Wyatt as the Health Insurance Benefit Consultant.

Ms. Charlotte Borchert seconded the motion.

By a vote of 9 in favor, 0 opposed, 0 abstentions, and 0 excused, the motion was approved.

5. Presentation, Discussion and Appropriate Action Regarding Notice of Docket Openings for:

A. System Rules

B. Repeal of Rules

Ms. Charlotte Borchert, Chairperson, Board Committee on Rules, explained that the Committee met and agreed to recommend the proposed notice of docket openings.

Motion: Ms. Borchert moved to approve the Notice of Docket Opening for the System Rules, Title 2, Chapter 8, Article 2 of the Arizona Administrative Code.

Ms. Borchert also moved to approve the Notice of Docket Opening for the System Rules, Title 2, Chapter 8, Article 1 of the Arizona Administrative Code.

Dr. Keith Meredith seconded the motion.

By a vote of 9 in favor, 0 opposed, 0 abstentions, and 0 excused, the motion was approved.

6. Presentation, Discussion and Appropriate Action Regarding Proposed Rule Making to Repeal Unnecessary Rules

Ms. Borchert explained that this is a recommendation that is required to repeal unnecessary rules that are no longer under our jurisdiction or are invalid due to statute changes.

Motion: Ms. Borchert moved to approve the Notice of Proposed Rulemaking for Repeal of Rules in Title 2, Chapter 8, Article 1 of the Arizona Administrative code.

Dr. Keith Meredith seconded the motion.

By a vote of 9 in favor, 0 opposed, 0 abstentions, and 0 excused, the motion was approved.

7. Presentation, Discussion and Appropriate Action Regarding the Following Issues and Activities:

A. Commitment to Customer Service

B. Status Report on Employer Services Program

C. Status Report on the Rural Health Insurance Supplemental Benefit Payment (Rural Subsidy)

D. Update on the Development of the Board Rules for the Distribution of Losses and Gains to System Members' Accounts and Benefits

E. State of the ASRS Contribution Rates and Anticipated Direction of Future Rates

Mr. Anthony Guarino, Deputy Director, Chief Operations Officer, and Mr. Richard Stephenson, Deputy Director, External Affairs, presented on this agenda item.

Mr. Guarino explained that the customer service demands on the ASRS continue to grow in volume and in difficulty. The ASRS has made the commitment to be more focused on the customer, and has identified ways to meet and exceed member demand for satisfying service.

Mr. Stephenson reported that the ASRS has been steadily improving its efforts in assisting member employers with timely information and answers to their questions. A series of Employer Conferences, updated printed materials and a revamped website, along with the work of the Employer Relations Section, is successfully keeping the employers connected.

Mr. Guarino reported on the status of the Rural Health Insurance Supplement Benefit Payment. This subsidy was authorized by the State Legislature in 2001 and expired on June 30, 2003. During the 2003 session, the State Legislature passed House Bill 2349, which extends the authorization for the ASRS to provide a Rural Subsidy. A few changes were mandated, including minimum out-of-pocket payments. The new subsidy begins September 18, 2003, with retroactive payments to July 1, 2003.

Mr. Stephenson provided an update on the development of Board Rules for the distribution of losses and gains to system members' accounts and benefits. The ASRS Board Committee on Rules is currently drafting rules that will affect System members. Several meetings have been held and the draft rules are available for public comment.

Further, Mr. Stephenson reported on the ASRS contributions rates and the anticipated direction of future rates. The new contribution rates for fiscal year 2003-04 took effect on July 1, 2003. Upward pressure on the ASRS fund placed by benefit enhancements as well as the performance of the bond and equity markets will likely have implications for future rates.

8. Presentation, Discussion and Appropriate Action Regarding ASRS Investments

A. Overview of the ASRS Investment Program

B. Financial Markets – Past & Present

C. ASRS Website – Investment Section

Mr. Gary Dokes, Acting Chief Investment Officer presented on this agenda item. He stated that the total market value of the ASRS was \$19.2 billion as of September 12, 2003. The ASRS invests in three major asset classes, U.S. Equities, International Equities, and U.S. Fixed Income. The ASRS' assets are invested in 30 portfolios. Twenty four of these portfolios are managed by 19 external portfolio managers. The remaining six portfolios are managed by the ASRS investment staff.

An asset allocation has been developed in an effort to determine which asset classes the ASRS should invest in. Asset Allocation is responsible for 80% to 90% of a fund's return. Manager selection, manager's security selection and market timing decisions account for about 10% to 20% of a fund's return.

Currently, the ASRS has 30% of its assets allocated to U.S. fixed income, 45% allocated to U.S. large cap equities, 4% to U.S. mid cap equities, 4% to U.S. small cap equities, and 17% to international equities. Effective October 1, 2003, the ASRS' asset allocation policy will change to allocations of 26% to U.S. fixed income, 43% to U.S. large cap equities, 5% to mid cap

equities, 5% to U.S. small cap equities, 15% to international equities, and 6% to institutional real estate.

Mr. Carl Tenney inquired as to how the ASRS will transition to the real estate allocation. Mr. Dokes stated that there is a process in place which includes hiring a real estate consultant. This consultant will assist the ASRS in devising a plan on how this money will be invested. The Investment Review Committee and the ASRS investment staff will be coming back to the Board with this plan.

Mr. Dokes highlighted the responsibilities of the Investment Management Division (IMD) as follows:

- Ensure monies are available to meet the Fund's cash flow needs.
- Ensure asset allocation targets are maintained, as mandated by the ASRS Board.
- Ensure all portfolios' strict compliance with ASRS Board Directives, portfolio guidelines, and Arizona Statutes.
- Effective management of six internally managed investment portfolios.
- Oversight of externally managed portfolios.
- Repository for investment expertise.

The internally managed portfolios are managed using the following strategies:

- E1 Model (U.S. Large Cap Equity Enhanced Passive)
- E2 Model (U.S. Large Cap Equity Passive)
- E3 Model (U.S. Mid Cap Value Equity Passive)
- E4 Model (U.S. Mid Cap Growth Equity Passive)
- F1 Model (U.S. Fixed Income Passive)
- F2 Model (U.S. Fixed Income Enhanced Passive)

The externally managed portfolios, which make up 63% of the fund or \$12.1 billion, are broken down as follows:

- U.S. Fixed Income (3 managers)
- U.S. Large Cap Equity (5 managers)
- U.S. Mid Cap Equity (3 managers)
- U.S. Small Cap Equity (4 managers)
- International Equity (4 managers)

Mr. Dokes touched on current and future activities in the IMD. First, the IMD will be reviewing the fixed income asset class and the development, implementation, and management of the ASRS institutional real estate program. Additionally, the IMD will be modifying the tactical asset allocation program. The investment manager oversight and maintaining experienced investment professional is done on a continuous basis.

Mr. Dokes talked about the past and present financial markets and highlighted the negative and positive aspects of the economy.

The ASRS has a website and within this site is an entire section dedicated to investments. Mr. Dokes explained that there is a wealth of information in this section such as investment strategies, rates of return (including historical rates of return), total fund performance, asset

allocation policy and the presentations that were given at past Board meetings pertaining to investments.

9. Presentation, Discussion, and Appropriate Action Regarding Operations of the ASRS
A. Overview of the ASRS
B. ASRS Status Update
C. Key ASRS Initiatives

Mr. Paul Matson, Director, touched on the overview of the ASRS. He stated that it is the ASRS' 50 year anniversary. The ASRS Board is comprised of nine Board members. The ASRS currently employs approximately 275 employees, including contractors. There are currently 675 member employers with approximately 370,000 members of the system.

With respect to the ASRS investments, Mr. Matson added the since Mr. Dokes was appointed Acting Chief Investment Officer, the year-to-date performance is up 4.2%.

Mr. Matson explained the contribution rates versus the cost to the System:

<u>Fiscal Year</u>	<u>Contribution</u>	<u>Cost</u>
2003-04	5.20%	11.90%
2002-03	2.00%	10.72%
2001-02	2.00%	10.72%
2000-01	2.17%	10.47%
1999-00	2.17%	10.47%
1998-99	2.85%	10.47%
1997-98	3.05%	10.41%
1996-97	3.20%	10.39%
1995-96	3.36%	10.39%

One of the key ASRS initiatives is the agency governance. The ASRS has hired a consultant to study this issue. The consultant has interviewed all senior staff members and all Board members and compared the ASRS with other organizations across the country and outside of this country. The consultant is in the final stages of this research and a summary of information is expected over the next several weeks. The objective is to identify the best practices for governance.

There have been additions to the ASRS' management staff:

Ms. Terry Cusker, Assistant Director, Member Services Division
Ms. Nancy Linssen, Assistant Director, Financial Services Division
Mr. Tom McClory, Assistant Attorney General, Arizona Attorney General's Office
Mr. Gary R. Dokes, Acting Chief Investment Officer, Investment Management Division

Mr. Matson discussed another key issue, Health Insurance. There have been four different bodies working on resolving health insurance issues, including legislative, the ASRS Board, Staff, and ASRS members. There are three main concepts that these bodies are attempting to obtain, including accessibility, sustainability and affordability of health insurance.

The Supplemental Retirement Savings Plan (SRSP) and Modified Drop are other key initiatives. Legislation was passed approximately two years ago which enabled the ASRS to offer the SRSP and Modified Drop program. Some issues have arisen such as obtaining a Private Letter Ruling from the Internal Revenue Service. The ASRS appears to be in the final stages of receiving the Private Letter Ruling. This would enable the ASRS to proceed with this program. A vendor has already been hired and is ready to administer the program. This plan is separate from the 457 plan currently administered by Nationwide.

The Information Technology Plan is a plan to modularize a series of systems. There are a number of issues involved with this plan. This plan will enable the ASRS to cut down on cost and also to provide improved responses to the ASRS members.

Mr. Matson provided an ASRS budget update. In summary, the ASRS received 18% less than was requested and 5% less than last fiscal year. Clearly, the ASRS will have to make some modest changes by cutting back on the hiring of full time employees. No one will see a cut in services with exception of reducing the number of times the newsletter is delivered during the year.

Finally, Mr. Matson discussed the key initiative of the Equity and Simplification Analysis. He explained that this plan was initiated a month ago. The plan ensures that the ASRS policies are reviewed for efficiency to control the increase of costs that may affect contribution rates and to ensure the same benefits are available to all members. Currently, the ASRS is reviewing and analyzing all legislation.

10. Director's Report

Mr. Matson had no comments on the Director's Report.

11. Board Requests for Agenda Items

Mr. Norman Miller requested a presentation on what system is in place to detect any possible improprieties or criminal actions of anyone associated with the System. Mr. Miller would like to have such a program in place.

12. Call to the Public

Mr. Bob Cooper asked how the ASRS internal investment portfolios compare with the external investment portfolios. Mr. Dokes directed Mr. Cooper to the website where this information can be found. The internally managed portfolios have met or exceeded their set objectives.

13. The next ASRS Board meeting is scheduled for Friday, October 17, 2003, at 8:30 a.m., in the 10th Floor Board Room of the ASRS Offices at 3300 N. Central Avenue, Phoenix, AZ 85012

14. Adjournment of the ASRS Board.

Mr. Jim Bruner, Board Member, adjourned the September 19, 2003, meeting of the ASRS Board at 11:08 a.m.

ARIZONA STATE RETIREMENT SYSTEM

Marina Chaves, Secretary

Date

Paul Matson, Director

Date